No. 36

In the Supreme Court of the United States

OCTOBER TERM, 1945

THE JOHN KELLEY COMPANY, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR THE RESPONDENT

INDEX

	Page
Opinions below	1
Jurisdiction	1
Question presented	2
Statutes and regulations involved	2
Statement	3
Summary of argument	15
Argument:	
I. The court below properly reversed the holding of the Tax Court, since, viewing the transaction from any angle, it has all the aspects of an issue of restricted preferred stock	22
A. The statutes involved and Regulations having the force of law, exclude, as interest deductions, distributions of earnings and profits to stockholders	22
B. Every provision of these "debentures" is characteristic of, or familiar to preferred stock	26
C. The Tax Court employed factors which are of no legal significance and ignored other relevant factors	37
D. The question whether the contract was an "indebtedness" turns on the meaning of that word as used in the statute and is therefore a question of law	45
II. The contract does not as a matter of law require the payment of "interest"	49
Conclusion	55

CITATIONS

Cases:	
Bakers' Mutual Coop. Ass'n v. *Commissioner*, 117 F. 2d 27	26, 28, 46
Bingham, Trust u/w of v. *Commissioner*, decided June 4, 1945	45, 47, 54
Brown-Rogers-Dixson Co. v. *Commissioner*, 122 F. 2d 347	25, 27
Cass v. *Realty Securities Co.*, 148 App. Div. 96, affirmed, 206 N. Y. 649	27, 32
Collier, Matter of, 112 Misc. 76 (N. Y.)	32
Commissioner v. *Disston*, decided June 4, 1945	47
Commissioner v. *Drovers Journal Pub. Co.*, 135 F. 2d 276	25, 51
Commissioner v. *Estate of Field*, 324 U. S. 113	47
Commissioner v. *Meridian & Thirteenth R. Co.*, 132 F. 2d 182	34, 46

Cases—Continued

	Page
Commissioner v. *Schmoll Fils Associated*, 110 F. 2d 611	27, 33, 52
Commissioner v. *Scottish American Co.*, 323 U. S. 119	44, 48
Crabb v. *Commissioner*, 121 F. 2d 1015	46
Crimmins & Peirce v. *Kidder Peabody Ac. Corp.*, 282 Mass. 367	34
Crane v. *Sheller Wood Rim Mfg. Co.*, 98 Ind. App. 310	34
Day v. *O. & L. C. R. R. Co.*, 107 N. Y. 129	32
Deputy v. *duPont*, 308 U. S. 488	25, 50, 51
Douglas v. *Commissioner*, 322 U. S. 275	24
Eastern Gas & Fuel A. v. *Commissioner*, 128 F. 2d 369	46
Equitable Society v. *Commissioner*, 321 U. S. 560	25, 44, 51, 53, 54
Fechheimer Fishel Co., In re, 212 Fed. 357, certiorari denied, *sub nom. Dellevie* v. *Fechheimer-Fishel Co.*, 234 U. S. 760	26
Fidelity Co. v. *Rothensies*, 324 U. S. 108	47
Fidelity Savings & Loan Ass'n v. *Burnet*, 65 F. 2d 477	35
Finance & Investment Corp. v. *Burnet*, 57 F. 2d 444	27, 34
Fondren v. *Commissioner*, 324 U. S. 18	47
Glaser, S., & Sons, Inc. v. *Commissioner*, decided May 22, 1944	37
Hamlin v. *Toledo, St. L. & K. R. Co.*, 78 Fed. 664	27, 29, 33
Hazel Atlas Glass Co. v. *Van Dyk & Reeves*, 8 F. 2d 716, certiorari denied, *sub nom. Van Dyk* v. *Young*, 269 U. S. 570	27, 46
Helvering v. *Winmill*, 305 U. S. 79	24
Kentucky River Coal Corp. v. *Lucas*, 51 F. 2d 586, affirmed, 63 F. 2d 1007	33, 34, 40
Lum v. *Commissioner*, 147 F. 2d 356	46
Mathews v. *Bradford*, 70 F. 2d 77	27
Midwood Associates, Inc. v. *Commissioner*, 115 F. 2d 871	46
New Colonial Co. v. *Helvering*, 292 U. S. 435	25
Old Colony R. Co. v. *Commissioner*, 284 U. S. 552	50
O'Neall, W. Q., Co. v. *O'Neall*, 108 Ind. App. 116	35
Pacific Southwest R. Co. v. *Commissioner*, 128 F. 2d 815, certiorari denied, 317 U. S. 663	24, 34, 36
Spies v. *Chicago & E. I. R. Co.*, 40 Fed. 34	30, 53
Taft v. *Commissioner*, 304 U. S. 351	24
Thomas v. *N. Y. & G. L. R. Co.*, 139 N. Y. 163	32
Union Pacific R. R. Co. v. *United States*, 99 U. S. 402	32
United States v. *South Georgia Ry. Co.*, 107 F. 2d 3	36
Warren v. *King*, 108 U. S. 389	27, 38
Welsbach Eng. & Management Corp. v. *Commissioner*, 140 F. 2d 584, certiorari denied, 322 U. S. 751	46
Whitridge v. *Mt. Vernon Woodberry Cotton Duck Co.*, 210 Fed. 302	31

Statutes:

Corporation Excise Tax Act of 1909, c. 6, 36 Stat. 11, Sec. 38	22
Income Tax Act of 1913, c. 16, 38 Stat. 114, 166, Sec. II G	22

Statutes—Continued

	Page
Internal Revenue Code:	
Sec. 23 (26 U. S. C. 1940 ed., Sec. 23)	3, 22
Sec. 115 (26 U. S. C. 1940 ed., Sec. 115)	3, 25
Sec. 719 (26 U. S. C. 1940 ed., Sec. 719)	39
Revenue Act of 1916, c. 463, 39 Stat. 756, Sec. 12	22, 23
Revenue Act of 1918, c. 18, 40 Stat. 1057, Sec. 234	22
Revenue Act of 1936, c. 690, 49 Stat. 1648:	
Sec. 23	2, 22
Sec. 115	3, 25
Revenue Act of 1938, c. 289, 52 Stat. 447:	
Sec. 23	3, 22
Sec. 115	3, 25
Miscellaneous:	
53 Cong. Record, Part II, p. 10656	23
1 Cook, Corporations (8th Ed.):	
Sec. 267	46
Sec. 273	29, 46
4 Cook, Corporations (8th Ed.), Sec. 773	32
6 Fletcher, Cyclopedia Corporations (Perm. Ed.):	
Sec. 2635	27, 46
Sec. 2644	32
Sec. 2645	32
11 Fletcher, Cyclopedia Corporations (Perm. Ed.) Sec. 5294	46
12 Fletcher, Cyclopedia Corporations (Perm. Ed.):	
Sec. 5447	29
Sec. 5451	35
Paul, *Dobson* v. *Commissioner:* The Strange Ways of Law and Fact, 57 Harv. L. Rev. 753 (1944)	46
Treasury Regulations 33 (Revised), Art. 185	23
Treasury Regulations 45, Art. 564	23
Treasury Regulations 94, Art. 23 (b)–1	3, 24
Treasury Regulations 101, Art. 23 (b)–1	3, 24
Treasury Regulations 103, Sec. 19.23 (b)–1	3, 24
Treasury Regulations 109, Sec. 30.719–1	38
Treasury Regulations 112, Sec. 35.719–1	39

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OPINIONS BELOW

The opinion of the Tax Court (R. 33–40) is reported at 1 T. C. 457; the opinion of the Circuit Court of Appeals (R. 55–59) is reported at 146 F. 2d 466.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on December 21, 1944. (R. 60.) The petition for a writ of certiorari was filed February 14, 1944, and was granted April 30, 1945. (R. 61.) The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether taxpayer-corporation was entitled to deduct as "interest" on "indebtedness" within the meaning of Section 23 (b) of the Revenue Act of 1936 and identical provisions of the Revenue Act of 1938 and the Internal Revenue Code, payments made during the taxable years to holders of its so-called "20 Year 8% Income Debenture".

STATUTES AND REGULATIONS INVOLVED

Revenue Act of 193[illegible], c. 690, 49 Stat. 1648:

> SEC. 23. DEDUCTIONS FROM GROSS INCOME.
> In computing net income there shall be allowed as deductions:
>
> * * * * *
>
> (b) *Interest.*—All interest paid or accrued within the taxable year on indebtedness, except on indebtedness incurred or continued to purchase or carry obligations (other than obligations of the United States issued after September 24, 1917, and originally subscribed for by the taxpayer) the interest upon which is wholly exempt from the taxes imposed by this title.
>
> * * * * *
>
> SEC. 115. DISTRIBUTIONS BY CORPORATIONS.
> (a) *Definition of Dividend.*—The term "dividend" when used in this title (except in section 203 (a) (3) and section 207 (c) (1), relating to insurance companies) means any distribution made by a corporation to its shareholders, whether in money

> or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.
>
> * * * * *

Sections 23 (b) and 115 (a) of the Revenue Act of 1938, c. 289, 52 Stat. 447, and of the Internal Revenue Code (26 U. S. C. 1940 ed., Secs. 23 and 115) are identical with the above.

Treasury Regulations 94, promulgated under the Revenue Act of 1936:

> ART. 23 (b)-1. *Interest.*—Interest paid or accrued within the year on indebtedness may be deducted from gross income, * * *.
>
> * * * * *
>
> * * * So-called interest on preferred stock, which is in reality a dividend thereon, can not be deducted in computing net income.

Article 23 (b)-1 of Treasury Regulations 101, promulgated under the Revenue Act of 1938 and Section 19.23 (b)-1 of Treasury Regulations 103, promulgated under the Internal Revenue Code, are identical with the above.

STATEMENT

Substantially all the facts were stipulated. (R. 33.) Others not stipulated were found by the Tax

Court from the record made at the hearing before it. (R. 34.)

Taxpayer is an Indiana corporation, organized in 1907, reorganized in 1930, operating a retail furniture store in Marion, Indiana. (R. 34.) The taxable years involved are the calendar years 1937, 1938, 1939; the returns were prepared on the accrual basis. (R. 34.) On January 1, 1937, the authorized capital stock of taxpayer consisted of 1,500 shares of common, no par value, and 3,000 shares of 6% preferred stock, $100 par value (R. 31); 1,110 shares of the common stock and 1,124 shares of the preferred stock were issued and outstanding and all of the outstanding stock, both common and preferred, was owned by Roy Kelley, individually and as trustee for his sister, Mabel Ronald (R. 34). During the month of January, 1937, Roy Kelley transferred the preferred stock owned by him individually (628 shares) to Mabel Ronald as trustee for her daughters, providing, however, that his wife, Birdena, should receive the income from this preferred stock during her lifetime. (R. 34.) In addition, he transferred outright some of the common stock owned by him individually (171 out of 567 shares) to his wife, Birdena. (R. 34, 36.) Mabel Ronald was president of the company and Roy Kelley was secretary, and they, plus Mrs. Ronald's daughter, Mary Louise Stogsdill, constituted its board of directors. (R. 35.)

On January 11, 1937, at a special meeting of this board of directors a plan of recapitalization

of taxpayer was adopted which was approved on the same day at a special meeting of the shareholders (Mabel Ronald and Roy Kelley). (R. 34–35.) The corporate resolution, thus adopted, provided for the following (R. 34–35):

> The change and increase of the 1,500 shares of no par common stock to 6,000 shares of $100 par value;
>
> The issuance of "income debenture bonds" aggregating the sum of $250,000, bearing 8% interest;
>
> The execution of a trust agreement setting forth the terms and conditions upon which the income debentures were to be issued and the duties and powers of the trustees;
>
> The offer of the new securities by the trustees in exchange for all the issued and outstanding 6% preferred stock, on the basis of $102 face value of the income debentures for each share of preferred stock;
>
> For the purpose of raising additional capital to expand the corporate business "in the field of finance", the sale by the trustees of additional debentures at par but only to the shareholders of taxpayer.

The resolution was executed in the following manner:

The trust indenture, as drawn, was dated back to January 1, 1937. (R. 35; Exhibit "F", R. 19–30.) The brother and sister, Mabel Ronald and Roy Kelley, were appointed and signed as trustees, and the same individuals, in their official capacity as president and secretary, respectively, signed on

behalf of taxpayer. (R. 30, 35.) None of the new securities were issued prior to July 1, 1937. On that date, the total outstanding 1,124 preferred shares then owned, as already noted, by Roy Kelley as trustee for his sister, Mabel Ronald (628 shares), and by Mabel, in turn, as trustee for her daughters (496 shares), were delivered to taxpayer in exchange for income debentures in the amount of $114,648. On the same date, Mabel Ronald and Roy Kelley's wife, Birdena, subscribed, respectively, for $24,408 and $10,944 of income debentures. However, these sums were not paid in cash but were carried as open accounts on the books of the corporation. Subsequently they were balanced by a credit of dividends paid by taxpayer on the common stock owned by them.[1] (R. 35.) Thus, the total income debentures issued aggregated $150,000 in face amount. (R. 36.)

On January 1, 1937, taxpayer's assets totaled $963,807.57 and its liabilities, exclusive of common and preferred stock, totaled $75,817.74. On December 31, 1937, its total assets were $982,221.08 and its total liabilities, exclusive of common stock and the debentures, were $46,158.19. (R. 36–37.)

[1] In the case of Mabel Ronald, the dividend was credited on the common stock held for her by Roy Kelley as trustee; in the case of Birdena Kelley, the dividend was on the 171 shares of common stock, which, as already noted, had been transferred to her by her husband on January 1, 1937. (R. 35.) The dividend was apparently paid on December 15, 1937, being $55 in cash and a stock dividend of 3½ shares. (R. 36.)

On taxpayer's books the "income debentures" were referred to as "stocks," "bonds," and "notes." Charges were entered in an account which was headed "accrued interest, income debentures." In its capital stock tax returns for 1938 and 1939, taxpayer listed "debenture" and "debenture notes," respectively, as capital stock. They were not reflected as indebtedness in the balance sheets appearing in the income and excess profits tax returns filed by taxpayer for 1937, 1938, and 1939, but appear under the heading "Capital Stock: Debenture Notes." Annual corporate resolutions were adopted authorizing the payment of "interest" on the "income debenture bonds" or "debenture notes." On most of the checks drawn for the "interest" on the "income debentures", the nature of the payment was described to be for "Interest, income debenture stock." (R. 36.)

The form of the debentures, insofar as material, was as follows (R. 17–18, Ex. "E"):

THE JOHN KELLEY COMPANY

20 YEAR 8% INCOME DEBENTURE

The John Kelley Company, an Indiana corporation, for value received, promises to pay to the bearer on the 31st day of December, 1956, the sum of

One Thousand Dollars ($1,000)

in lawful money of the United States of America at the office of the Company in

Marion, Indiana, and to pay interest thereon in like lawful money, out of the net income of the Company, at the rate of 8% per annum, payable annually on the 31st day of December of each year, at the office of the Company in Marion, Indiana, on presentation of this Debenture for endorsement of payment thereon, conditioned, however, upon the net income of the Company being sufficient during any interest period to pay the amount due as interest, in accord with the terms and provisions hereof. The interest on this Income Debenture shall not be cumulative.

This debenture bond is * * * entitled to all the benefits specified in a trust agreement dated January 1, 1937, made by and between The John Kelley Company and Mabel K. Ronald and Roy F. Kelley, as Trustees, to which trust agreement reference is hereby made for a description of the rights of the holders of such debentures, and of the Trustees with respect to the enforcement thereof.

This debenture may be redeemed at the option of the Company on any interest date prior to maturity upon notice in the manner and upon the terms provided in the trust agreement by payment of its principal amount and accrued interest to the date of redemption; after such redemption date, interest on the debentures called for redemption shall cease unless payment thereof shall be refused after presentation. All debentures purchased or redeemed by the Trustees shall be cancelled and not reissued.

If any of the events of default specified in the trust agreement shall occur, all debentures outstanding hereunder may be declared to be due and payable in the manner and with the effect provided in the trust agreement.

In the payment of their claims, all creditors, other than the stockholders of the Company, shall rank superior to the holders of this income debenture, but all holders of this income debenture shall rank pari passu with each other and superior to the stockholders of the corporation with respect to their share stock.

* * * * *

Additional provisions contained in the trust agreement, so far as pertinent, were as follows (R. 23, 24–25, 27–28):

ARTICLE II.

COVENANTS OF THE COMPANY.

* * * * *

SECTION 2. The Company covenants that there are no liens or encumbrances on its real or personal property, and that so long as any of the debentures issued hereunder are outstanding the Company will not mortgage, pledge, or otherwise encumber any of its real or personal property owned at the date hereof or hereafter acquired.

SECTION 3. The Company covenants that so long as any of the debentures issued hereunder are outstanding, it will at all times keep all its buildings, plants, equipment, merchandise and fixtures and other

insurable property properly insured against loss or damage by fire to the extent that such property is usually insured by companies operating retail stores and properties of a similar character.

SECTION 4. The Company covenants that so long as any of the debentures issued hereunder are outstanding it will pay to the holders thereof the full amount of interest stipulated to be paid therein before it shall declare a dividend to the holders of the common stock of the Company.

* * * * * * *

ARTICLE IV.

DEFAULT AND REMEDIES.

SECTION 1. If one or more of the following events of default happen, viz.: (a) if default be made in the punctual payment of any installment of interest on any outstanding debenture or debentures or (b) if default be made in the observance or performance of any of the terms of said debentures or of this Trust Agreement, and any such last named default shall continue for a period of two (2) years after written notice thereof shall have been given to the Company by the Trustees (whose duty it shall be to give such notice at the request in writing of at least twenty-five per cent (25%) in principal amount of the debentures at the time outstanding hereunder), then and in every such case, the Trustees may, and upon the written request of the holders of twenty-five per cent (25%) in

principal amount of the debentures then outstanding hereunder shall declare the principal of all debentures then outstanding hereunder to be due and payable immediately, and upon any such declaration the same shall become immediately due and payable, anything in this Trust Agreement or in said debentures contained to the contrary notwithstanding.

This provision, however, is subject to the conditions that if at any time after the principal of said debentures shall have been so declared due and payable, and before any judgment or decree for the payment of monies due shall have been entered, all arrears of interest upon all the debentures shall have been duly paid and all defaults shall have been made good, and all the stipulations of said debentures and of this Trust Agreement shall have been fully performed by the Company, then, and in every such case, the holders of a majority in principal amount of the debentures then outstanding, by written notice to the Company and to the Trustees, may waive such default and its consequence and rescind such declaration; but no such waiver of rescission shall extend to or affect any subsequent default or impair any right consequent thereon.

SECTION 2. The company covenants that (a) in case default shall be made in the punctual payment of any installment of interest on any outstanding debenture or debentures and such default shall have continued for a period of two (2) years;

or (b) in case default shall be made in the payment of the principal of any such debenture or debentures when the same shall become payable, whether upon maturity or upon call or declaration as provided in this Trust Agreement, then upon demand of the Trustees the Company will pay to the Trustees for the benefit of the holders of the debentures issued hereunder and then outstanding, the whole amount which then shall have become due and payable on all such debentures then outstanding and in addition thereto such further amount as shall be sufficient to cover the costs and expenses of collection, including a reasonable compensation to the Trustees, their agents, attorneys and counsel, and any expenses or liability incurred by the Trustees hereunder. In case the Company shall fail forthwith to pay such amount on such demand, the Trustees in their own names and as Trustees of an express trust shall be entitled and empowered to institute such action or proceeding at law or in equity, as may be advised by counsel, for the collection of the sums so due and unpaid and may prosecute any such action or proceeding to judgment or final decree and may enforce any such judgment or decree in the manner provided by law.

* * * * *

SECTION 5. No holder of any income debenture issued hereunder shall have the right to institute any action or proceeding in equity or at law upon said debenture or debentures, or for the enforcement of any

of the terms of this Trust Agreement, unless and until such holder shall have previously given to the Trustees written notice of a default of the Company in the performance of one or more of the stipulations of said debentures or of this Trust Agreement and its continuance as hereinbefore provided, and also unless or until the holders of twenty-five per cent (25%) (or in case of the prohibitions or negative covenants hereof, the holders of 10% as hereinabove provided) in principal amount of the debentures outstanding shall have made written request of the Trustees and shall have offered to said Trustees indemnity to their satisfaction against the costs, expenses and liabilities to be incurred by said Trustees, and shall have afforded to the Trustees a reasonable opportunity to exercise the powers herein granted to enforce this Trust Agreement, and the Trustees shall have refused or unreasonably delayed to comply with such request.

Provided, however, that nothing in this Trust Agreement shall affect or impair the obligation of the Company, which is unconditional and absolute, to pay at the date of maturity therein expressed the principal of the debentures to the respective holders thereof, or affect or impair the right of action of such holders to enforce such payment, subject only to the prior right of the Trustees, if exercised promptly in accordance with the terms of this Trust Agreement.

The debenture holders had no right to participate in the management of the business. (R. 39.)

The preferred stock for which the debentures had been exchanged provided that it should have as against the common stock a first lien on the assets of the corporation, subject to the rights of creditors, and entitled each year out of surplus and net profits to "a fixed dividend" of 6% payable semiannually on the first days of January and July, before common stock dividends. (R. 31.). The preferred stock dividends were cumulative. In the event of liquidation, assets were first to be applied to the claims of creditors, then to preferred stockholders at par and accumulated dividends, before the common stock. At the option of the company the preferred stock might be redeemed or retired at any dividend period at $102 per share, together with unpaid dividends. (R. 31–32, Ex. "G".)

Taxpayer claimed in its income tax returns for the years 1937, 1938, and 1939, as interest deductions upon the aggregate face amount of $150,000, payments made to debenture holders of $6,000, $12,000, and $12,000, respectively. The Commissioner disallowed these deductions. (R. 36.) The Tax Court overruled the Commissioner (R. 39–40), and the court below, reversing the Tax Court, sustained the Commissioner (R. 55–59).

SUMMARY OF ARGUMENT

I

A. By Section 23 (b), Congress has granted a deduction for "interest" paid on an "indebtedness" in order to permit a subtraction from gross income of a fixed and definite charge on the taxpayer's operations which often may constitute a cost, certain in character, incurred in the earning of income. But the legislative history, the statutes and the Regulations having the force of law make it clear that a deduction is not allowable for earnings and profits distributed by a taxpayer corporation to the proprietors of its business. The legislative history establishes that since the inception of the income tax, Congress and the Treasury have recognized the potentiality for misapplication of the interest deduction through masquerade of dividends distributed on preferred stock in the guise of interest payments on indebtedness, and have steadfastly manifested the intent to preclude such a construction. Furthermore, interest like other deductions, being a matter of legislative grace, does not turn upon general equitable considerations; only if there is clear provision therefor may the deduction be allowed. The rule of construction is strict, and the burden is upon the taxpayer of proving that there was an "indebtedness" and that "interest" was paid upon it.

B. The terms of the contract do not require the payment of interest nor give rise to an indebted-

ness. Every provision of these "debentures" is familiar to preferred stock. The name borne by the certificates is of little importance. The substantial legal rights and duties, which the agreement creates, are the determining factors and the misuse of words cannot change the legal conclusions which follow from these rights and obligations.

The income feature bears a close resemblance to capital stock. These payments, like dividends, are limited to a distribution of net corporate earnings or profits during a given year, and are not cumulative. Should there be no net income for a given annual period, no claim for payments survives, and neither may it be asserted at the time of the alleged "maturity" of the security. Again, as in the case of dividends, the distribution is essentially dependent upon the directors' discretion, and the instant agreement, as security for the payment of interest, is actually no more than the pledge of the good faith of the company in managing its business. Similarly, as with dividends, the exercise of the directors' discretion, as to what part of the earnings shall be used for alterations, repairs, other expenses, payment of current obligations, depreciation, and other reserves, and what balance remains as net income for distribution to holders of these securities, is unlimited in the absence of bad faith, and a mistake of judgment will afford no ground of complaint. Essentially, a certificate holder here, like a stockholder, is merely

an adventurer in the corporate business; he profits only from its success, and lacking such success, he contracts for and is entitled to no return upon his money whatsoever. The long continued Treasury Regulations, denying a deduction of "so-called interest on preferred stock, which is in reality a dividend thereon", are here clearly applicable.

Again, it is immaterial that the contract did not authorize the certificate holders to participate in management, or that it contains an agreement against future encumbrance of the corporate property. Such provisions are common in the case of preferred stock. On the other hand, the covenant in the trust indenture that, so long as any of the debentures are outstanding, taxpayer will pay the holders the full amount of "interest" before declaring a dividend to common stockholders, possesses significance only if the certificates create the rights and obligations of preferred stock. If the certificates actually constitute indebtedness, as taxpayer claims, no such protection is required, for the obligation to pay net income is then absolute, irrespective of dividend declarations.

Finally, a right to repayment of investment at a definite time is a proper and not uncommon provision of preferred stock, always subject, as here, to the rights of creditors. Thus, the certificate holders are here again precisely in the position of preferred stockholders, since at maturity they

rank inferior to all creditors, superior only to other stockholders. If misfortune overtakes the company, their investment is subject to the payment of every debt. Besides, the remedies afforded the certificate holders in the event of default, do not differ materially from those frequently accorded to preferred stockholders. In any case, no default can occur in the payment of "interest", unless the directors in the exercise of managerial discretion permit income to remain unexpended at the end of a given annual period; hence, the possibility of default is dependent upon the taxpayer's discretion and good faith, and the certificate holders' rights are not absolute, as in the case of a debt. Thus, viewing the transaction from any angle, it has all the aspects of preferred stock.

C. In its opinion the Tax Court listed what it termed "the determining factors" (R. 40), and then proceeded to apply them. It did not indicate the weight to be ascribed to any factor. It disposed of factors which would have supported a conclusion contrary to that which it reached by the simple statement that each in itself was not decisive. It failed to list and take into account other factors with respect to which it had made findings of fact and which the court below believed to be important. Its conclusion was not substantially supported by any factor. The Circuit Court of Appeals did not undertake to weigh the factors which the Tax Court relied upon. The

method which the Tax Court here expressly employed in testing its fact findings establishes that its conclusion is arbitrary and amply justifies reversal by the court below. The court below in no way controverted the fact findings of the Tax Court; on the contrary, it made the only holding based on the Tax Court's findings which is legally sufficient, namely, a holding that the transaction did not involve the payment of genuine interest on genuine indebtedness. Where, as here, the record is destitute of evidence to support a finding—the taxpayer having the burden—it was the duty of the reviewing court to reverse an order resting upon such a finding.

D. Moreover, the Government not only contends that the court below properly reversed the Tax Court, since its treatment of the uncontroverted facts was arbitrary, but further urges whether the agreement creates "indebtedness" within the meaning of the statute, is a question of law which the court below rightly decided. The terms of the agreement, as found by the Tax Court, are not challenged. The question whether the contract obligated the payment of "indebtedness" turns on the meaning of these words as used in the statute and is consequently a question of law. The case therefore depends upon the legal effect of language, as contained in uncontroverted written agreements, which has repeatedly been held to be a question of law subject to appellate review. Moreover, here Congress has incorpo-

rated familiar common law conceptions of contract and property law into the Revenue Act, with respect to which the Tax Court has no special competence. In any event, this Court has frequently re-examined, as matters of law, determinations by the Tax Court of the meaning of the words of the statute as applied to facts found by that tribunal. While it is true that no two agreements are exactly alike, the controversy here does not therefore become factual. The principle of law involved is the meaning of the statute, and to hold that the contract constitutes an "indebtedness" will materially alter and expand in general application the meaning of "indebtedness" in the statute.

II

Furthermore, the contract does not, as a matter of law, require the payment of "interest". Thus, even assuming *arguendo* that these certificates represent an "indebtedness", payments of this uncertain, indefinite and discretionary character limited to corporate earnings cannot as a matter of law constitute "interest" within the meaning of the statute. It is not enough for taxpayer to establish that an "indebtedness" exists and that a sum, which is not "interest", has been paid in connection with or in consideration for the indebtedness; the burden is affirmatively upon it to establish that it has paid strictly "interest". Congress has allowed a deduction only of "in-

terest" and proof that the payment is "interest" remains the primary prescription of the statute. These payments which are contingent upon (a) the existence of earnings; (b) their existence during a given calendar year, and (c) exercise of managerial discretion by the directors substantially as broad as that which exists in the case of dividends on stock, have a degree of uncertainty which the notion of interest ordinarily lacks. Certainly they do not satisfy a strict rule of construction, and Congress intended strictly "interest" to be deducted and nothing else. The question is one of law, namely, whether on the basis of the agreement the income payments sought to be deducted were "interest" within the meaning of the revenue acts. The principle of law involved is the meaning of the statute; to include the payments in the instant case, contingent upon the existence of earnings during a given calendar year and upon the exercise of a broad managerial discretion by directors, will in general radically alter and expand the meaning of interest in all applications.

ARGUMENT

I

THE COURT BELOW PROPERLY REVERSED THE HOLDING OF THE TAX COURT, SINCE, VIEWING THE TRANSACTION FROM ANY ANGLE, IT HAS ALL THE ASPECTS OF AN ISSUE OF RESTRICTED PREFERRED STOCK

A. The statutes involved and Regulations having the force of law, exclude, as interest deductions, distributions of earnings and profits to stockholders

The statutes involved permit deductions of "all interest paid or accrued within the taxable year on indebtedness". (Section 23 (b), Revenue Acts of 1936 and 1938 and Internal Revenue Code, *supra*, p. 2.) This language is to be found substantially unchanged in successive revenue acts for many preceding years beginning (as applying to corporations) with the Revenue Act of 1918, c. 18, 40 Stat. 1057, Section 234 (a) (2). Previously the Corporation Excise Tax Act of 1909, c. 6, 36 Stat. 11, Section 38, Second, had limited the deduction to—

> interest actually paid within the year on its bonded or other indebtedness to an amount of such bonded and other indebtedness not exceeding the paid-up capital stock of such corporation, * * *.

The Income Tax Act of 1913, c. 16, 38 Stat. 114, 166, Section II G (b), contained a similar provision, as also did the Revenue Act of 1916, c. 463, 39 Stat. 756, Section 12 (a), Third. These early limitations upon the privilege of interest deductions by corporations were explained on the

floor of Congress, during the debate in the House on the 1916 Act (53 Cong. Record, Part II, p. 10656) as follows:[2]

> the original theory of the matter was that corporations could issue quite a lot of watered stock, transfer that into bonds, mortgage their property, and incur interest, and make a great many shifts in many ways that would result in avoiding the real purpose of the law. This bill allows them to deduct interest on an amount of indebtedness double their capital stock.

The 1916 Act contained further an express provision (Section 12 (a), Third):

> That for the purpose of this title preferred capital stock shall not be considered interest-bearing indebtedness, and interest or dividends paid upon this stock shall not be deductible from gross income * * *.

The Treasury Regulations promulgated under this Act (Treasury Regulations 33 (Revised), Art. 185) first contained the provision:

> So-called interest on preferred stock, which is in reality a dividend thereon, can not be deducted in arriving at the net income.

This regulation was repeated in Treasury Regulations 45, under the Revenue Act of 1918, Article 564, where, as noted above, the general language of the statute, so far as pertinent, is the same as

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[2] This explanation was made by a member of the Committee on Ways and Means, Mr. Hull.

that contained in the Revenue Acts presently involved. Moreover, the quoted regulation has been continued without substantial change up to the present time. (Article 23 (b)–1 of Regulations 94 and 101 and Section 19.23 (b)–1 of Regulations 103, *supra*, p. 3.) On familiar principles Treasury Regulations, long continued without substantial change, are deemed to have received Congressional approval and have the force of law. *Taft* v. *Commissioner*, 304 U. S. 351, 357; *Helvering* v. *Winmill*, 305 U. S. 79, 83; *Douglas* v. *Commissioner*, 322 U. S. 275, 281–282; *Pacific Southwest R. Co.* v. *Commissioner*, 128 F. 2d 815, 817 (C. C. A. 9th), certiorari denied, 317 U. S. 663.

Moreover, this legislative history further establishes that substantially during the entire history of the income tax, Congress and the Treasury have recognized the potentiality for misapplication of the interest deduction through masquerade of dividends distributed on preferred stock in the guise of interest payments on indebtedness, and have steadfastly manifested the intent to preclude such a construction. Indeed, this distinction is fundamental, for its basis is seen in the very principle upon which the interest deduction is founded. In the exercise of legislative grace, Congress has granted the interest deduction in order to permit a subtraction from gross income of a fixed and definite charge on the taxpayer's operations, which often may constitute a cost, certain in character, incurred in the earning of income. Clearly, on

the other hand, the legislative history, the statutes and the Regulations, having the force of law make it clear that the interest deduction is not applicable to mere distributions of exclusion of deductions for earnings and profits distributed by a taxpayer corporation to the proprietors of its business. Such distributions the relevant statutes define as dividends (Section 115 (a) of the Revenue Acts of 1936 and 1938 and Internal Revenue Code, *supra*, p. 2):

> *Definition of Dividend.*—The term "dividend" * * * means any distribution made by a corporation to its shareholders, * * * out of its earnings or profits. * * *.

Furthermore, interest like other deductions is a matter of legislative grace. The rule of construction is strict. It does not turn upon general equitable considerations; only if there is clear provision therefor can any particular deduction be allowed. *Equitable Society* v. *Commissioner*, 321 U. S. 560, 564; *New Colonial Co.* v. *Helvering*, 292 U. S. 435, 440; *Deputy* v. *duPont*, 308 U. S. 488, 493; *Brown-Rogers-Dixson Co.* v. *Commissioner*, 122 F. 2d 347, 350 (C. C. A. 4th). The burden is upon the taxpayer of showing that the deduction claimed clearly falls within the terms of the statute, and, thus, includes the burden of proving that there was an "indebtedness" and that "interest" was paid upon it. *Commissioner* v. *Drovers Journal Pub. Co.*, 135 F. 2d 276, 278, 279 (C. C. A. 7th).

B. Every provision of these "debentures" is characteristic of or familiar to preferred stock

Viewing the agreements involved the question is, do their provisions create an "indebtedness" and prescribe the payment of "interest"? Here, as the court below rightly held (R. 59):

> Every provision of these debentures is a frequent and authorized clause familiar to preferred stock.

True, the nomenclature employed is that of debt, the instrument is called a "20 Year 8% Income Debenture" or a "debenture bond". (R. 17.) Taxpayer "promises to pay" the principal sum "and to pay interest". (R. 17.) However, it is well settled that (*In re Fechheimer Fishel Co.*, 212 Fed. 357, 360 (C. C. A. 2d), certiorari denied, *sub nom. Dellevie* v. *Fechheimer-Fishel Co.*, 234 U. S. 760)—

> the fact that an instrument is called a "bond" is not conclusive as to its character. It is necessary to disregard nomenclature and look to the substance of the thing itself.

The substantial legal rights and duties which the agreement creates are the determining factors. The misuse of words of art cannot change the legal conclusions which follow from these rights and obligations. *Bakers' Mutual Coop. Ass'n* v. *Commissioner*, 117 F. 2d 27, 28 (C. C. A. 3d). If an instrument is described as a bond and it is not a bond but preferred stock, and if payments are referred to as interest and, in truth, they are profit distributions, then they are not governed by the principles applicable to bonds and interest

payments. The legal rights and duties themselves—not what they are called—must be examined; on the face of the agreement, they alone are decisive. *Hazel Atlas Glass Co.* v. *Van Dyk & Reeves,* 8 F. 2d 716, 720 (C. C. A. 2d), certiorari denied, *sub nom. Van Dyk* v. *Young,* 269 U. S. 570; *Commissioner* v. *Schmoll Fils Associated,* 110 F. 2d 611, 613 (C. C. A. 2d); *Brown-Rogers-Dixson Co.* v. *Commissioner, supra,* p. 349; *Cass* v. *Realty Securities Co.,* 148 App. Div. 96, 100 (N. Y.), affirmed, 206 N. Y. 649; 6 Fletcher, Cyclopedia Corporations (Perm. Ed.), Sec. 2635. The Treasury Regulations, *supra,* which prohibit the deduction of "so-called interest * * * which is in reality a dividend thereon" have already been discussed. Thus, calling dividends "interest" does not make them interest. *Warren* v. *King,* 108 U. S. 389, 399; *Hamlin* v. *Toledo, St. L. & K. R. Co.,* 78 Fed. 664, 669 (C. C. A. 6th); *Finance & Investment Corp.* v. *Burnet,* 57 F. 2d 444, 445 (App. D. C.); *Mathews* v. *Bradford,* 70 F. 2d 77, 79 (C. C. A. 6th). In this light let us examine the legal rights and obligations expressed in the contract under consideration.

1. There is no certainty that the holder will receive a periodic return. The contract provides that "interest" is payable annually on December 31 of each year (R. 17)—

> out of the net income of the Company, at the rate of 8% * * * *conditioned,*

> however, upon the *net income* of the Company *being sufficient during any interest period* to pay the amount due as interest, in accord with the terms and provisions hereof. The interest on this Income Debenture shall *not* be *cumulative*. [Italics supplied.]

Thus, the payment of so-called "interest" is not merely dependent upon there being earnings, i. e., gross earnings, but upon there being profit, i. e., "net income". The payments accordingly are limited exclusively to a distribution of the corporate earnings or profits during a given year. Characteristically such distributions are dividends. As the court said, in *Bakers' Mutual Coop. Ass'n* v. *Commissioner, supra* (p. 28):

> The taxpayer argues that even if there was not an unconditional obligation to pay interest on the certificates, certainly there was an obligation to pay the interest if there were profits. But such a distribution of corporate earnings comes within the definition of a dividend in the Revenue Act 1932, § 115, 26 U. S. C. A. Int. Rev. Acts, page 520, and therefore this argument is unavailing.

Further, the payments do not even possess the assurance of preferred dividends,[3] but like common stock, dividends are not cumulative. Should

[3] Preferred dividends, unless express provision is made to the contrary, are cumulative. 1 Cook, Corporations (8th Ed.), Sec. 273; 12 Fletcher, *supra*, Sec. 5447.

there be no net income for a given annual period, no claim for payment survives; neither may it be asserted at the time of the alleged "maturity" of the security. The certificate holder here assumes the risks of a proprietor. He is merely an adventurer in the corporate business; he profits only from its success, and lacking such success, he contracts for and is entitled to no return upon his money whatsoever.

Interest is a certain payment whose amount is known in advance; here, on the other hand, the parties never can know, except as a maximum, the amount payable in advance; in addition, being noncumulative, no one can compute—even assuming solvency—the definite amount of income, which will be received, over the approximate twenty years of the agreed term. The same is true of common stock. In holding that similar provisions constituted dividends, not interest, the Circuit Court of Appeals for the Sixth Circuit in *Hamlin* v. *Toledo, St. L. & K. R. Co., supra,* said (pp. 669–670):

> That these shares are declared to carry "interest at the rate of four per cent. per annum, payable semiannually, represented by coupons attached," is not conclusive that they are debt obligations. By calling a dividend "interest," the essential nature of the thing is not changed. We must look deeper. When we do so, we find that this "interest" is to be paid only out of "the net earnings" after paying interest upon the

> first mortgage bonds, "and the cost of maintenance and operation." We further find that this so-called "interest" is "noncumulative." The net earnings of each year are to be ascertained. If there are none, after paying interest on the first mortgage bonds and operating expenses and expenses of maintenance, no "interest" is to be paid; and when, at any time, such a happy state of affairs is found to exist as a surplus, so that anything can be paid upon the current year's "interest," all past due coupons for "unearned interest" are to be surrendered. Thus, this "interest" has all the characteristics of a preference, in dividends to the extent of four per cent. per annum, over the common stock, and none of the marks of interest proper.

Moreover, as in the case of dividends, the distribution is essentially dependent upon the directors' discretion, which, if exercised in good faith, the certificate holder cannot control. As said in *Spies* v. *Chicago & E. I. R. Co.*, 40 Fed. 34, 38 (C. C. S. D. N. Y.):

> *An income railway mortgage,* * * * *is, as a security for the payment of interest, but little more than the pledge of the good faith of the company in managing its lines.* It necessarily contemplates that such improvements as seem necessary to the efficient use and operation of such property, and such alterations in the *corpus* as appear desirable, are to be made, at the discretion

> of the directors; and unless it contains some limitations upon the powers of the directors, express or implied, the right of the company to conduct its operations as it may see fit, subject only to the conditions of its organic law, is unqualified; and consequently the company can lawfully extend its lines, acquire new ones, discontinue old ones, and thus essentially change the earning capacity of the property. [Italics supplied.]

There are here no contractual restrictions on the power of the directors. Such income payments are further subject to the directors' discretion to retain portions of gross income as reserves against depreciation. *Whitridge* v. *Mt. Vernon Woodberry Cotton Duck Co.*, 210 Fed. 302, 310 (Md.).

Since the "bonds" are to run for approximately twenty years and the earnings are to be determined at the end of each year, in the meantime, certainly, it was not intended that the business remain stationary. Precisely as in the case of dividends, the exercise of the directors' discretion as to what part of the earnings shall be used for alterations, repairs, other expenses, payment of current obligations, depreciation and other reserves, and what balance remains as *net* income for distribution to holders of these securities, is unlimited in the absence of bad faith. A mistake in judgment as to the necessity or extent of

expenditures will afford no ground of complaint by the security holders. The power of control by the directors, as compared to that existing in the case of stockholders, is substantially unimpaired, and as a practical matter, it is left to them to ascertain whether any of the company's earnings shall be paid to these certificate holders. *Union Pacific R. R. Co.* v. *United States*, 99 U. S. 402, 404, 420–423; *Day* v. *O. & L. C. R. R. Co.*, 107 N. Y. 129, 146–148; *Thomas* v. *N. Y. & G. L. R. Co.*, 139 N. Y. 163, 183–184; 6 Fletcher, *supra*, Sec. 2645.

In truth, securities providing for income payments of this character "bear a close resemblance to capital stock" [4] (6 Fletcher, *supra*, Sec. 2644, p. 476). See also 4 Cook, *supra*, Sec. 773, p. 3520:

> The same difficulty that is experienced in ascertaining whether there are net profits for a dividend is experienced in ascertaining whether there is a surplus properly applicable to income bonds.

Thus, irrespective of whether "income bonds" may in some instances be considered "indebtedness", we contend that the noncumulative provisions of the instant securities, combined with their other features, establish them to be stock, rather than bonds.

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[4] An income "bond" was held preferred stock within the meaning of the New York inheritance tax statute in *Matter of Collier*, 112 Misc. 70, 72–74 (N. Y.), following *Cass* v. *Realty Securities Co.*, *supra*, pp. 100–101.

2. It is immaterial that the contract did not authorize the certificate holders to participate in the management of the business. Such is commonly the case with preferred stockholders. *Commissioner* v. *Schmoll Fils Associated, supra,* p. 613.[5] Again, preferred stock issues frequently contain, as here, an agreement against future encumbrance of the corporate property. (R. 23.) *Hamlin* v. *Toledo, St. L. & K. C. R. Co., supra,* p. 670; *Kentucky River Coal Corp.* v. *Lucas,* 51 F. 2d 586 (W. D. Ky.), affirmed without opinion, 63 F. 2d 1007 (C. C. A. 6th).

On the other hand, the covenant in the trust indenture that (R. 23)—

> so long as any of the debentures issued hereunder are outstanding it [the company] will pay to the holders thereof the full amount of interest stipulated to be paid therein before it shall declare a dividend to the holders of the common stock of the Company

is meaningless if these certificates actually constitute indebtedness, since, if the obligation to pay net income is absolute, as taxpayer claims, no such protection is requisite. However, if the instrument, as the Government contends, creates the rights and obligations of preferred stock, then the clause quoted from the agreement possesses

[5] As a matter of fact, the certificate holders, a small family group, were the managers of the business, since the corporate resolution authorizing issuance of the debentures prescribed that they be offered to shareholders only. (R. 35, 57.)

significance. As this court said in *Warren* v. *King, supra,* (pp. 398–399):

> The interest to be paid to them is not to be paid absolutely, as to a creditor, but only out of net earnings, the same fund out of which the dividends on common stock are to be paid. Though called "interest", it is really a dividend, because to be paid on stock and out of net profits.

3. Finally, a right to payment at a definite time is recognized as a proper and not uncommon provision of preferred stock, always subject, by implied or as here by express agreement, to the rights of all creditors. The certificate remains, nevertheless, stock, not indebtedness. *Kentucky River Coal Corp.* v. *Lucas, supra,* p. 588; *Finance & Investment Corp.* v. *Burnet, supra,* p. 445; *Pacific Southwest R. Co.* v. *Commissioner, supra; Commissioner* v. *Meridian & Thirteenth R. Co.,* 132 F. 2d 182 (C. C. A. 7th); *Craig* v. *Sheller Wood Rim Mfg. Co.,* 98 Ind. App. 310, 320;[6] *Crimmins & Peirce* v. *Kidder, Peabody Ac. Corp.,* 282 Mass. 367, 374–376. The certificate holders are here precisely in the position of such preferred stockholders. At "maturity" they "rank" inferior, not to a class or classes of secured creditors, or to some creditors, but to "all creditors", superior only to other stockholders. (R. 18.) If

[6] Taxpayer is an Indiana corporation (R. 34); the court below, sitting in a circuit which includes Indiana, noted that preferred stock, having maturity date, is authorized by Indiana law (R. 58).

misfortune overtakes the company, their investment is subject to the payment of every debt. In *Fidelity Savings & Loan Ass'n* v. *Burnet*, 65 F. 2d 477 (App. D. C.), where the right of withdrawal existed at any time—not postponed to a date approximately twenty years hence—the Court of Appeals of the District of Columbia held the certificate to represent stock, not indebtedness. There also, income was payable out of earnings (p. 480), while the shareholder (p. 481)—

> had, it is true, the advantages of withdrawal which the holder of permanent stock did not have, but this advantage accrued only during the solvency of the corporation.

The remedies afforded the certificate holders here do not differ materially from those frequently accorded preferred stockholders. Indeed, the remedy of a preferred stockholder to enforce payment of his dividend is ordinarily more substantial than that here afforded the certificate holder to compel payment of his so-called interest. *W. Q. O'Neall Co.* v. *O'Neall*, 108 Ind. App. 116; 12 Fletcher, *supra*, Sec. 5451. As a matter of fact, the trust agreement affords no remedy by suit for the collection of a so-called interest instalment in the event of nonpayment. If such default continues for a period of two years, then the trustees may, or upon written request of holders of 25% in principal amount of the certificates then outstanding, must demand payment of the principal

amount.[7] (R. 24–25). However, similarly, in the event of default in dividend payments, preferred stockholders are by agreement frequently given control of the company and are in a position to compel dissolution and withdrawal of their investment.[8]

Moreover, no "default" in the sense in which that word is understood in the case of a debt is possible, for the certificate holders' rights are not absolute but are dependent upon the taxpayers' discretion and good faith. Thus, no "default" can occur in the payment of "interest" unless, as already noted, the directors in the exercise of broad managerial discretion permit income to remain unexpended at the end of a given year and thereafter fail to pay to the certificate holders such surplus income; furthermore, the right to payment is always subordinate to the claims of general creditors.

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[7] Before the maturity date expressed in the certificate, no holder has the right to sue on the instrument unless the trustees fail to act after 25% of the certificate holders have made written request to the trustees and offered indemnity. (R. 27.)

[8] Cf. *United States* v. *South Georgia Ry. Co.*, 107 F. 2d 3, 5 (C. C. A. 5th), where the court said:

"The certificates contain provisions usual in preferred certificates for cumulating the dividends and for giving the preferred shareholders the right to take measures to protect their rights as holders of preferred stock, extending to causing the appointment of a receiver for, and if necessary, liquidating the company."

See also *Pacific Southwest R. Co.* v. *Commissioner*, *supra*, p. 817.

To summarize, no case has been found in the federal courts, where noncumulative payments out of net income have been allowed as interest deductions. Indeed, outside of the instant case, the only holding in the Tax Court to the contrary is a memorandum decision, *S. Glaser & Sons, Inc.* v. *Commissioner,* decided May 22, 1944 (1944 P-H T. C. Memorandum Decisions, par. 44, 170). (R. 59.) Nor has an unsecured contract been held to be an indebtedness within the meaning of the revenue laws where, as here, withdrawal of investment is subject to claims of all creditors and where the so called interest is in large measure discretionary, being noncumulative and payable only out of net earnings, limited to an annual period.

C. The Tax Court employed factors which are of no legal significance and ignored other relevant factors

In its opinion the Tax Court listed what it termed "the determining factors" (R. 40), and then proceeded to comment upon them. It did not indicate the weight to be ascribed to any factor. It disposed of the factors, which would have supported a conclusion contrary to that which it reached, by a simple statement that each in itself was not decisive. It failed to list and take into account other factors with respect to which it had made findings of fact and which the court below believed to be important. In a case where the facts may be subjected to several

tests, all having legal significance, and when after being so tested, some point in one direction and others in a different direction, we do not doubt that the decision of the Tax Court is entitled to controlling weight. But that is not to say that the reviewing court is precluded from determining whether or not the various tests which the Tax Court has applied are themselves, in the light of the findings, of legal significance. It is one thing to weigh the evidence, but whether or not a given factor, which is expressly applied to the evidence, is entitled to any legal significance under the findings, is another matter. The Circuit Court of Appeals did not undertake to weigh the factors which the Tax Court relied upon; on the contrary, it held only that the factors which the Tax Court thought should be applied are as a matter of law without significance. Accordingly, we submit that the method which the Tax Court here expressly employed in testing its fact findings and its application are here arbitrary and amply justify reversal by the court below.

The determining factors which the Tax Court listed and applied as tests are[9] (R. 40)—

[9] Compare Treasury Regulations 109, relating to the Excess Profits Tax under the Internal Revenue Code as amended by the Second Revenue Act of 1940, applicable to the taxable years beginning after December 31, 1939, i. e., to taxable years subsequent to those here involved, reading as follows (Sec. 30.719–1 (b)):

"Whether outstanding certificates designated by such names as 'denbenture preferred stock' or 'guaranteed pre-

the name given to the certificates, the presence or absence of maturity date, the source of the payments, the right to enforce the payment of principal and interest, participation in management, status equal to or inferior to that of regular corporate creditors, and intent of the parties.

1. The name given to an instrument is of little importance, as already noted, *supra*, pp. 26–27. The legal rights and duties which the agreement creates—not what they are called—are the determining factors. Moreover, since there was no consistency in the use of the name here, the "debentures" sometimes being called "stock" (R. 36), the name given could not reasonably support taxpayer's contention; at the most it is a neutral factor.

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ferred stock' constitute borrowed capital depends upon whether the holder has a proprietary interest in the corporation or has the rights of a creditor, determined in the light of all the facts. The name borne by the certificate is of little importance. More important attributes to be considered are whether or not there is a maturity date, the source of payment of any "interest" or "dividend" specified in the certificate (whether only out of earnings or out of capital and earnings), rights to enforce payment, and other rights as compared with those of general creditors."

Section 35.719–1 (d) of Treasury Regulations 112, likewise relating to the Excess Profits Tax under the Internal Revenue Code as amended for taxable years beginning after December 31, 1941, is identical. Section 719 of the Internal Revenue Code, to which this regulation refers, provides for the inclusion in invested capital for excess profits tax purposes of 50% of borrowed capital. The regulation thus follows the court decisions, which have interpreted the interest deduction.

2. The maturity date could not on this record reasonably be held to constitute a positive factor indicating a distinction between bond and stock, for, as already noted, *supra,* pp. 34–35, a right to payment at a definite time is not unusual today for preferred stock and is in fact authorized by Indiana corporation law. Besides, here at maturity the certificate holders are precisely in the position of preferred stockholders, ranking inferior to all creditors, superior only to other stockholders. No significance as a matter of law in support of a holding that these instruments are indebtedness can here be given to the maturity date, since if enforcement rendered the corporation incapable of meeting its obligations, the right of the holders would precisely as in the case of preferred stock be subordinated to the rights of general creditors. *Kentucky River Coal Corp.* v. *Lucas, supra.*

3. The source of the payments here is a factor which clearly points in the direction of classifying these debentures as stock, *supra,* pp. 28–32. So-called interest is to be paid only out of income and only out of such net income as may remain after the exercise of managerial discretion by the directors, substantially as in the case of dividends on stock. Once the annual period has passed lacking such net income, no claim for payment survives; neither may it be asserted at the time of the alleged "maturity" of the security. The Tax Court disposed of this factor merely by the comment that it "is not decisive". (R. 40.) How-

ever, even if, *arguendo,* we agree, nowhere did the Tax Court in its express application of these separate determining factors point to any other factors sustaining the opposite conclusion which clearly outweighed it.

4. Neither in the circumstances does the right to enforce payment of principal and interest in the case of default afford positive support to the Tax Court's conclusion. As discussed *supra,* pp. 35–37, the remedy of a preferred stockholder to enforce payment of his dividend is ordinarily more substantial, than that here afforded the certificate holder, to compel payment of his so-called interest. Besides, by reason of the express terms of the agreement, the certificate holder's rights upon default in payment of interest are not absolute, for "interest" is dependent upon taxpayers' discretion and good faith. Again, the remedy afforded as to principal at maturity is assimilated to the remedy of preferred stockholders upon failure of a corporation to redeem at maturity, for the latter also are frequently given the right to compel return of their investment by liquidation, however, always as here, subject to the rights of creditors. Certainly this factor does not justify classifying the certificate holders as stockholders.

5. Again, the status of the certificate holders inferior to that of ordinary corporate creditors is glossed over by the Tax Court's observation that it "is not of itself conclusive". (R. 40.) Here too, the Tax Court in applying the test of the

determining factors has not explained what other factors outweigh this clear weakness in the taxpayer's case.

6. The circumstance that debenture holders did not have a right to participate in management does not distinguish them from preferred stockholders, who commonly are deprived of these rights. Indeed, the facts which the Tax Court found indicate the contrary to be the case here, namely, that the debenture holders, a small family group, are the managers of the business, and the corporate resolution, limiting issuance of the debentures to shareholders only, assured this result. (R. 35, 57.)

7. With respect to the factor of "intent of the parties" (R. 40), the Tax Court made a final comment (R. 40):

> It is apparent that the holders of the preferred stock, in exchanging the stock for "20 year 8% income debentures," preferred the debtor-creditor status of debenture holders to that of stockholders, and stockholders have the right to change the creditor-debtor basis, though the reason may be purely personal to the parties concerned.

However, the question is whether the rights and obligations which the contract creates amount to an indebtedness, not what the parties "intended". We think it clear error for the Tax Court to hold that the personal preference of the stockholders can sustain a conclusion that the instrument is a

debt, not stock. A corporate taxpayer having the burden of establishing that it comes within the class for whose benefit a deduction is allowed does not carry that burden by establishing merely that its stockholders "preferred" the debtor-creditor status. On the contrary, the exchange of the preferred stock for the debentures did not affect in any substantial way the previously existing interest of the stockholders.

The business was a closely held family corporation, all the outstanding common stock being owned by Roy Kelley, his wife, Birdena, and his sister, Mabel. The preferred stock was all owned either individually or as trustee by Roy Kelley and his sister. (R. 34–36, 56.) She was president of the company and he was secretary, and they, plus one of her daughters, constituted its board of directors. (R. 35, 56.) The trust indenture, underlying the certificates, was signed on behalf of taxpayer by Roy Kelley and his sister; they also were appointed the trustees and likewise signed the indenture in that capacity. (R. 30, 35, 56.) The only persons, who by corporate resolution were permitted to subscribe to the new certificates, were shareholders of the company. (R. 35, 57.) Hence, the new issue could involve no change in management; the holders of the "debentures" were in fact the managers of the business. Moreover, the issue involved the raising of no additional capital because the subscriptions by Mabel Ronald and Mrs. Kelley for $24,408 and $10,944 of the new certificates in excess of exchanges of

preferred stock were paid by a credit of dividends on the common stock owned by them. (R. 35, 36, 57.) No substantial business purpose and only one of tax avoidance appears for this retirement of the 6% preferred stock in exchange for 8% debentures by a small, well-established company, in a good credit position, engaged in a retail business, which was able in a slack business year to pay a cash dividend of $55 and a stock dividend of 3½ shares for one. (R. 36, 37, 57.)

The Tax Court completely failed to take these factors into account. There is certainly an air of unreality to the entire transaction which justifies the opinion of the Circuit Court of Appeals that it was nothing but "accounting hocus-pocus". (R. 59.)

The court below in no way controverted the fact findings of the Tax Court; on the contrary, it made the only holding based on the Tax Court's findings which is legally sufficient, namely, a holding that the transaction did not involve the payment of genuine interest on a genuine indebtedness. *Equitable Society* v. *Commissioner, supra,* pp. 563–565; *Commissioner* v. *Scottish-American Co.,* 323 U. S. 119, 124. The Circuit Court of Appeals has not undertaken to re-weigh the factors which the Tax Court relied upon. Where the record, as here, is destitute of evidence to support a finding—the taxpayer having the burden—it was the duty of the reviewing court to reverse an order resting upon such a finding.

D. The question whether the contract was an "indebtedness" turns on the meaning of that word as used in the statute and is therefore a question of law

Moreover, the Government not only contends that the court below properly reversed the Tax Court, since its treatment of the evidence was arbitrary in holding as determinative separate factors which here as a matter of law are not entitled to significance, and since the record does not afford substantial support to the conclusion which it reached, but further urges that whether the agreement creates "indebtedness" within the meaning of the statute, is a question of law which the court below rightly decided and the Tax Court incorrectly decided.

The terms of the agreement are in writing, were all found by the Tax Court and are not challenged. (R. 55.) The question whether these contract terms, as thus found by the Tax Court, provide for payment of "interest" on an "indebtedness" depends upon the meaning of these words as used in the statute, and (*Trust u/w of Bingham* v. *Commissioner*, No. 932, decided by this Court June 4, 1945, not yet reported)—

> are therefore questions of law, decision of which is unembarrassed by any disputed question of fact or any necessity to draw an inference of fact from the basic findings.

The case is not one for the weighing of evidence and the resolution of testimonial differences, in which the court below would have been bound by the facts as the Tax Court found them, but one

for determination of the legal effect of the language, as contained in the uncontroverted agreements in writing. *Hazel Atlas Glass Co.* v. *Van Dyk & Reeves, supra,* p. 720. The legal conclusion to be drawn from the terms used is for the court. *Baker's Mutual Coop. Ass'n* v. *Commissioner, supra,* p. 28; *Commissioner* v. *Meridian & Thirteenth R. Co., supra,* pp. 188–189. The determination by the Tax Court of the rights and obligations arising from a written contract has, moreover, repeatedly been held to be a question of law subject to appellate review. *Midwood Associates, Inc.* v. *Commissioner,* 115 F. 2d 871, 872 (C. C. A. 2d); *Crabb* v. *Commissioner,* 121 F. 2d 1015 (C. C. A. 5th); *Eastern Gas & Fuel A.* v. *Commissioner,* 128 F. 2d 369, 373 (C. C. A. 1st); *Welsbach Eng. & Management Corp.* v. *Commissioner,* 140 F. 2d 584, 586 (C. C. A. 3d), certiorari denied, 322 U. S. 751; *Lum* v. *Commissioner,* 147 F. 2d 356 (C. C. A. 3d).

Again, Congress has here incorporated familiar common law conceptions of contract and property law into the revenue act, which long have on common law principles been the subject for consideration by courts generally.[10] Hence, these questions do not fall peculiarly within the special competence of the Tax Court. See Paul, *Dobson* v. *Commissioner:* The Strange Ways of Law and Fact, 57 Harv. L. Rev. 753, 847–848 (1944).

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[10] For example, cf. 6 Fletcher, *supra,* Sec. 2635; 11 Fletcher, *supra,* Sec. 5294; 1 Cook, *supra,* Secs. 267, 273.

In the *Bingham* case, *supra*, this Court recently said:

> Since our decision in the *Dobson* case [*Dobson v. Commissioner*, 320 U. S. 489, rehearing denied, 321 U. S. 231] we have frequently re-examined, as matters of law, determinations by the Tax Court of the meaning of the words of a statute as applied to facts found by that court.

citing in a footnote a number of such instances.[11] In *Fondren* v. *Commissioner*, 324 U. S. 18, and *Commissioner* v. *Disston*, No. 589, decided June 4, 1945, not yet reported, this Court considered the provisions of particular trust agreements for the purpose of determining whether, within the meaning of the gift tax statute there involved, the obligations, which they expressed, amounted to "future interests". Again, in *Commissioner* v. *Estate of Field*, 324 U. S. 113, the question of law was whether the obligations of a particular trust agreement within the meaning of the relevant Revenue Act constituted a transfer intended to take effect in possession or enjoyment at or after death. Cf. *Fidelity Co.* v. *Rothensies*, 324 U. S. 108, 109–110. In the *Bingham* case, the question was whether under the terms of the particular trust, property was held for the production of income within the meaning of the Revenue Act. Here, the question is what the statute means by "indebtedness", and to re-examine as a matter of law the determination by the Tax Court of this

[11] *Bingham* case, *supra*, fn. 1.

meaning as applied to the agreement found by that tribunal.

These cases may be contrasted with *Commissioner* v. *Scottish American Co.*, 323 U. S. 119, where no problem of legal obligation or property right was involved, nor of construction of a written agreement; but whether or not on a state of substantially undisputed facts the Tax Court was entitled to infer that taxpayer corporations had or had not, as a matter of fact, an office or place of business within the United States during the years in question. The ultimate question there was not one of legal obligation or of property right, but of the existence of a particular state of facts. Thus, this Court said (pp. 123, 125):

> The sole issue revolves about the propriety of the inferences and conclusions drawn from the evidence by the Tax Court. * * *
>
> * * * * * *
>
> We cannot say that it was unreasonable for the Tax Court to conclude that this office was more than a sham and that it was used for the regular transaction of business. Hence it was proper as a matter of law for the Tax Court to classify the taxpayers as resident foreign corporations under § 231 (b).

Clearly the decision there did not turn, as does the question here, upon the determination of whether or not a contract gives rise to certain legal obligations within the meaning of the statute, but on whether (p. 124)—

> the *factual* inferences and conclusions of the Tax Court are supported by substantial evidence. [Italics supplied.]

The question of law here is whether on the basis of the provisions of the agreement, the income payments sought to be deducted were "indebtedness" within the meaning of the Revenue Acts involved. While it is true that no two agreements are exactly alike, the dispute here does not therefore become factual. Cf. *Fondren, Disston, Field* and *Bingham* cases, *supra*. The principle of the law involved is the meaning of the statute, and to hold that the contract here constitutes an indebtedness will materially alter and expand in general the meaning of "indebtedness" in the law.

II

THE CONTRACT DOES NOT AS A MATTER OF LAW REQUIRE THE PAYMENT OF "INTEREST"

The opening sentence of the Tax Court's opinion stated the issue of the case at bar to be only (R. 39)—

> If the debentures have created an indebtedness the payments to the holders thereof are interest and deductible as expense, but if they are in fact capital stock the payments are dividends and not deductible.

Thus, the Tax Court assumed as a matter of law that if the taxpayer's "income debentures" evidence "indebtedness" the payments made thereon

were necessarily "interest"; and it was on that assumption of law that it held that they were. We think that such assumption was erroneous; and that our contention in the court below that it was erroneous raised an issue of law which that court was authorized to consider and pass upon.

Hence, even assuming, *arguendo,* that these certificates represent an indebtedness, payments of this uncertain, indefinite, and discretionary character limited to corporate earnings cannot as a matter of law constitute "interest" within the meaning of the statute. Congress has allowed a deduction only of "interest" and proof that the payment is an "interest" payment remains the primary prescription of the statute; it is not enough for taxpayer to establish that an "indebtedness" exists and that a sum, which is not "interest", has been paid in connection with or in consideration for the indebtedness; the burden is affirmatively upon him to establish that he has paid strictly "interest". This Court has held that "interest" is used in this statue in its "usual, ordinary and everyday meaning" (*Old Colony R. Co.* v. *Commissioner,* 284 U. S. 552, 561); and that (p. 560) "the usual import of the term is the amount which one has contracted to pay for the use of borrowed money."

Again, in *Deputy* v. *duPont, supra,* this Court said (p. 498): "We are dealing with the context of a revenue act and words which have today a well-known meaning." Thus, all carrying charges

are not interest (*Deputy* v. *duPont, supra,* p. 497), nor amounts ascribed to a time period prior to the date the loan was made (*Commissioner* v. *Drovers Journal Pub. Co., supra*), although the contract for the use of the money includes a binding promise to pay them. Such agreements do not fall within the ordinary meaning of the term in the context of the statute.

In the context of the pertinent Revenue Acts and of the long-standing Regulations construing them, so-called "interest", which is in reality a dividend, cannot be deducted. The deduction which Congress intended was not a contingent, discretionary distribution of earnings and profits, but a fixed and definite charge, known in advance, collectible absolutely, as a debt against the taxpayer's entire assets, in the nature of a cost of the business.

This Court has recently held in *Equitable Society* v. *Commissioner,* 321 U. S. 560, 564, *supra,* that—

> payments made wholly at the discretion of the company have a degree of contingency which the notion of "interest" ordinarily lacks

even though there (p. 564) "the obligation to pay the principal amount * * * was absolute", and the so-called "interest" was not conditioned on the existence of surplus or earnings. In the instant case the analogy to dividends is more perfect in the respect that the payments could be

made only out of earnings, and indeed, the source of the payments is even more limited than is commonly true in the case of dividends, for here the payment may not be made out of surplus or earnings of past years, but is restricted to "the net income * * * during any interest period" (R. 17), i. e., during a given calendar year. Moreover, as also already discussed, the directors' discretion is substantially as broad and untrammeled as that accorded in the case of dividend declarations; in practice, the only distinction is a formal one. In both cases the amount to be distributed is a balance remaining after the directors have exercised their unlimited judgment in the use of the gross corporate earnings for expenses, repairs, current obligations, and reserves; in the case of the dividend, a formal declaration is necessary, but this, particularly where the stock is preferred, may not arbitrarily be denied. As the Second Circuit Court of Appeals said, referring to similar income provisions (though there cumulative), in *Schmoll Fils Associated, supra* (p. 613):

> Almost the only difference between the debenture holders and holders of cumulative preferred stock is that the former may require payment of their interest out of any net earning of the company, whereas preferred stockholders are able to compel payment of a dividend only in case the directors arbitrarily refuse to declare it.

The administration of a great revenue system is an intensely practical matter; Congress did not intend a shadowy distinction of this character to be treated as real. These income payments are clearly not comprehended within the meaning of "interest", as used in the statute. They are in reality dividends and pursuant to the long-standing Regulations, they are not allowable. These payments are here contingent upon (a) the existence of earnings; (b) their existence during a given calendar year (uncertainties additional to those present in the *Equitable Society* case); and (c) the exercise of managerial discretion by directors substantially as broad as that which exists in the case of dividends on stock. To expand the meaning of the term "interest" to include the payments involved in the instant case, as this Court said in the *Equitable Society* case (p. 564), "would indeed relax the strict rule of construction which has obtained in case of deductions under the various Revenue Acts." Certainly, the instant agreement does not satisfy a strict rule of construction; and Congress intended strictly "interest" to be deducted and nothing else. An obligation, limited to distribution of earnings of a given year, which amounts to "but little more than the pledge of the good faith of the company in managing" its business (*Spies* v. *Chicago & E. I. R. Co., supra,* p. 38), does not conform to the businessman's notion of

interest, nor fall within the purview of the statute.

Finally, in *Equitable Society* v. *Commissioner, supra,* which originated in the Tax Court, this Court decided the question whether (p. 564)—

> on the basis of the provisions of policies and the meager stipulation that the excess interest dividends were "interest" within the usual meaning of the Act as a matter of law.

Substantially this is the question of law here, namely, whether on the basis of the provisions of the agreement, the income payments sought to be deducted were "interest" within the meaning of the Revenue Acts involved. As already noted, this Court has frequently re-examined, as a matter of law, determinations by the Tax Court of the meaning of the words of a statute as applied to the facts found by that court. *Bingham* case, supra.[12] The principle of law involved is the meaning of the statute; to include the payments in the instant case, contingent upon the existence of earnings during a given calendar year and upon the exercise of a broad managerial discretion by directors, amounting to little more than a pledge of good faith, will in general radically alter and expand the meaning of "interest" in all applications.

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[12] Cf. cases cited in fn. 1 of opinion in *Bingham* case, *supra.*

CONCLUSION

The decision of the Circuit Court of Appeals is correct and should be affirmed.

Respectfully submited.

HAROLD JUDSON,
Acting Solicitor General.
SAMUEL O. CLARK, JR.,
Assistant Attorney General.
J. LOUIS MONARCH,
MARYHELEN WIGLE,
I. HENRY KUTZ,
Special Assistants to the Attorney General.

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